

Hedge Fund Industry in Canada

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My name is Jim McGovern and I am the chairman of the Canadian Chapter of the Alternative Investment Management Association (or “AIMA Canada”) and with me is Gary Ostoich who is legal counsel to AIMA Canada. We would like to thank the Standing Senate Committee on Banking, Trade and Commerce for the opportunity to meet and provide information to you regarding the hedge fund industry in Canada.

In the time that we have been allotted to speak with you today, we wanted to provide you with the following information:

1. background regarding AIMA Canada;
2. information relating to hedge funds and their role in capital markets;
3. size and constituents of the Canadian hedge fund market;
4. regulation of hedge fund products in Canada;
5. address some current issues relating to hedge funds; and
6. comment on the future of the Canadian hedge fund industry

Background on AIMA

AIMA Canada is a chapter of the Alternative Investment Management Association (“AIMA”) established in the United Kingdom in 1990 as a direct result of the growing importance of alternative investments in global investment management. AIMA is a not-for-profit educational and research body that represents practitioners and institutional investors in hedge funds, managed futures and managed currency funds in addition to suppliers to the industry such as prime brokers, administrators, lawyers and accountants.

AIMA’s global membership comprises some 700 members in 43 countries. AIMA has significant and active member groups in various countries around the world including the UK, France, Italy, Germany, Netherlands and Switzerland; it also has chapters in Australia, Hong Kong/China, Japan, Singapore, South Africa and Canada. AIMA Canada was established in 2003 and has grown to over 70 corporate members including some of the largest institutional investors in Canada as well as some of the largest Canadian based hedge funds and funds of hedge funds.

AIMA works closely with regulators around the world and other interested parties in order to better promote responsible use of alternative investments. AIMA provides regulators with complimentary copies of educational material produced by it or on its behalf, in addition to both formal and informal discussions with regulators, whenever those appear useful and helpful, AIMA frequently responds on behalf of its members to consultation processes initiated by regulators. Examples of regulatory initiatives and material undertaken or published by AIMA Canada are the following:

1. Guide to Sound Practices for Canadian Hedge Fund Managers which provides Canadian managers with an overview of the many issues that should be considered by a hedge fund manager who manages funds in Canada;
2. AIMA Canada Hedge Fund Primer which provides an investor with background relating to hedge funds as an asset class.
3. Providing comments and feedback on various industry regulatory guidelines and rules (eg. National Instrument 81-106).

We are currently working on a paper to be released later this month entitled “Guide to Sound Practices for Disclosure and Promotion of Alternative Investments,” which contains detailed guidelines on disclosure and promotion of hedge fund products in Canada.

Definition of Hedge Funds

In December 2004, the Bank of Canada stated in its 2004 Financial System Review that “the term ‘hedge fund’ covers a very diverse field of organizations and behaviour that defy any simple definition.”

Generally, a hedge fund is a private investment fund limited to a small number of sophisticated clients who each invest relatively large sums of money. These investors rely on the expertise of portfolio managers to generate returns. The hedge fund industry is smaller than the traditional mutual fund industry, not only because of their limited capital raising opportunities, but also because they need to remain nimble enough to make profitable trades or investments without significant market impact.

Hedge funds are often described as absolute-return investments. This means that, unlike traditional mutual funds, hedge funds do not link their performance to any index or benchmark. Instead, hedge funds use the skill of their portfolio managers to implement proprietary trading strategies to generate returns independent of the movement of the broader market.

Although there are over 25 different classes of investment strategies that hedge funds may engage in, most hedge funds in Canada fall into a few categories. The most common investment strategy for Canadian hedge funds is the equity long/short strategy, in which a hedge fund will purchase stocks it believes will rise in price and will sell short stocks it believes will decline in price, thus generating a profit in both rising and falling market conditions. Another common strategy is the market neutral strategy, which is a variant of the equity long/short strategy in which long and short positions are matched so that the fund has limited exposure to the overall market direction. Less common investment strategies in Canada include the convertible arbitrage strategy, in which positions in convertible debt are hedged by selling short the underlying shares, and managed futures strategies which are based on capitalizing on trends in a variety of global markets such as currency and interest rate markets.

Additionally, some hedge funds use other hedge funds as their primary investments, thus creating portfolios or funds of hedge funds. Funds of hedge funds offer investors exposure to a variety of investment strategies selected by portfolio managers with considerable experience in the hedge fund marketplace.

Role and Benefits of Hedge Funds in the Marketplace

Hedge funds provide significant benefits to investors as well as the broader financial markets.

The benefits to investors include portfolio diversification because hedge fund returns traditionally have little or no correlation to the returns of more traditional stock and bond investments. Accordingly, hedge funds offer investors such as pension funds and other investors the opportunity to reduce portfolio volatility and enhance portfolio returns in economic environments in which traditional stock and bond investments offer limited opportunities. Hedge funds also provide investors with the opportunity to generate returns by investing in non-financial markets such as commodities.

Hedge funds also benefit the financial markets by performing a number of vital roles. For example, hedge funds can act as “shock absorbers” in the marketplace, by investing in volatile markets when other investors choose to remain on the sidelines. Hedge funds can also often act as “whistle blowers” on companies, identifying, through shareholder activism, the shares of those companies which hedge funds believe have issues with its business or its corporate governance which can often signal to corporate boards, other market participants or regulators that a problem may exist with a public company. Hedge funds also add depth and liquidity to all areas of the capital markets, which contributes to efficiencies in pricing and promotes market stability. Finally, hedge funds often act as effective “risk transfer” conduits in the capital markets – particularly in the area of corporate and high yield credits.

Size and Constituents of Canadian Hedge Fund Market

The Canadian hedge fund market has continued to evolve and expand in recent years. As at June, 2004 total assets in Canadian hedge funds and hedge fund related products totalled over \$20 billion. As recently as 1999, the Canadian market was made up of less than 50 hedge funds with roughly \$2.5 billion in assets under management. By June 2004, the market had grown to approximately 190 hedge funds and hedge fund related products with \$26.6 billion in assets. This should be placed in the context of the global hedge fund marketplace which is now over \$1 trillion (US) in assets.

Approximately \$14.1 billion of hedge fund investments in Canada are owned by individual investors with approximately 50% of that amount held via principal protected notes issued by highly rated financial institutions and government entities. However, Canadian pension plan assets represent a significant amount of the funds invested in

hedge funds. In fact, over 40% of hedge fund investments in Canada are held by institutional investors.

The \$14.1 billion hedge fund market in Canada consists of both single manager hedge funds and funds of hedge funds.

Of the 190 or so hedge funds in the Canadian market place about 55% are single manager funds. The average asset size of a single manager fund in Canada is approximately \$39 million. The average asset size of a fund of hedge funds in Canada is slightly higher at \$44 million.

In addition to individual hedge fund managers, banks, mutual fund companies and insurance companies are also active in offering hedge funds and hedge fund related products to Canadian investors.

Several traditional mutual fund companies have supplemented their “long-only” investment funds by establishing alternative investment funds employing strategies such as “short-selling” and modest leverage which are traditionally associated with hedge funds.

Several banks have also begun to offer hedge fund related products, such as principal protected deposit notes. These products offer “principal protection” because at maturity an investor will receive at least their principal back together with a return linked to the performance of a hedge fund, typically a fund of funds. These principal protected products are primarily offered in the retail sector. They provide retail investors with exposure to the hedge fund sector without having to meet a large minimum investment or “accredited investor” rules (discussed below) which are typically required for a direct investment in a hedge fund. In recent years, the principal protected products have gained an increasing share of the hedge fund products in Canada.

Regulation of Hedge Fund Products in Canada

Alternative investments such as hedge funds can be structured in a variety of ways, but regardless of the legal form, the regulation applicable to the offering, promotion and sale of the securities of a hedge fund is similar.

Money managers such as mutual fund managers and hedge fund managers need to be registered with provincial securities commissions in order to manage money for clients. The requirement to register with securities regulatory authorities to provide portfolio management services is an expensive and time consuming process which involves demonstrating significant previous experience to securities regulators as well as developing and maintaining a comprehensive compliance program for the money management firm. As a money manager registered with a provincial securities commission, a hedge fund manager is subject to a compliance audit by securities regulators.

Access to public markets in Canada is subject to numerous regulations that are intended to maintain the integrity of the Canadian financial market and protect investors. Hedge funds which offer their securities in Canada or to Canadian residents must comply with these regulations.

In Canada, hedge funds are marketed in the retail market and the exempt market. The retail market refers to distribution to the general investing public by way of prospectus offerings or other offerings that are not subject to or are exempt from securities regulations (such as principal protected bank note offerings). The most frequently relied upon exemptions used to sell hedge fund products are the “accredited investor” and “pooled fund” exemptions as well as the principal protected bank note offerings.

The accredited investor exemption allows institutional investors and individuals with net assets or income above a certain threshold to invest in non-prospectus offerings. The pooled fund exemption allows investors who invest greater than a specified dollar amount in a single fund to participate in non-prospectus offerings. It is worthwhile to mention that despite the growth in the high-net worth segment of the exempt market, much of the investment in hedge funds tends to come from institutional investors including pension funds, governments and Canadian and global funds of hedge funds.

As stated previously, retail investors have begun to constitute a larger source of investors for Canadian hedge funds and Canadian distributors due to the advent of various structured products that are either exempted from the application of the prospectus rules or are offered by way of a prospectus. Some common products include prospectus offered exchange listed non-redeemable investment funds, whose returns are linked to the performance of hedge funds, and principal protected hedge fund linked bank deposit notes.

Aside from securities regulations, Canadian hedge fund managers are also required to comply with provincial and federal privacy legislation in connection with the collection, use, disclosure and disposal of personal information about their investors. It should be noted that hedge funds are also subject to certain reporting requirements under Canadian anti-money laundering and anti-terrorist financing legislation.

There are also restrictions on the advertising and promotional strategies that Canadian hedge funds can employ. For instance, securities legislation generally prohibits promotion of privately offered investments in securities on radio or television. Subject to strict guidelines, in certain Canadian jurisdictions, hedge funds are permitted to advertise an offering of securities to accredited investors in newspapers and other print media.

Current Hedge Fund Issues in the Press

Not unlike the bank lending market which experiences problem loans from time to time, the hedge fund market has also had its share of problem hedge funds and problem distributors of hedge funds. In some cases, Canadian institutional investors have been caught off guard by problems that have occurred with respect to hedge funds situated and managed outside of Canada such as investments by the City of Montreal, the University

of Montreal, the Chagnon Foundation, Bombardier and others in Lancer. In other cases, Canadian funds have experienced losses or other problems which have resulted in Canadian hedge funds being closed down and liquidated.

Recently, two Canadian hedge fund related issues have been highlighted by the press: Portus Alternative Asset Management based in Toronto (“Portus”) and Norshield Financial Group based in Montreal (“Norshield”). Portus reportedly sold approximately \$750 million in fund of hedge funds products to 26,000 retail investors across Canada and is being investigated by various securities commissions for violating securities laws. It is being alleged that Portus improperly offered their products to non-accredited investors. In addition, it is alleged that neither Portus nor its distributors conducted the necessary due diligence and suitability tests with respect to recommending their products to investors.

Norshield reportedly managed approximately \$450 million in fund of funds products for mainly high net worth and institutional investors. Norshield recently announced to investors that they were preventing any further redemptions from their funds pending an orderly liquidation of their underlying investments.

Although both Portus and Norshield are still being reviewed by several securities regulators across Canada and final determinations regarding their situations have not yet been made, it appears that the issues surrounding these firms are very different in nature and should not be seen as hedge fund issues, even though both Portus and Norshield were involved in the hedge fund business.

From our perspective, the Portus situation primarily involves a compliance issue as well as a due diligence issue. The compliance issue relates to sales practices and disclosure, as well as the “suitability” of the fund for retail investors. The due diligence issue relates to the referred selling practices involving regulated third parties who participated in the marketing and distribution of Portus products.

The case of Norshield appears to be quite different – this appears to be a case of a basic “run on the fund” by investors caused by a number of factors including bad publicity in Quebec relating to litigation. This has caused a liquidity problem in certain of Norshield’s underlying funds. One of the risks in investing with hedge funds, which is similar to other investments such as private equity, is that if too many investors want to exit a fund on a given date, the fund may not have enough liquidity to allow all investors to exit the fund and a “gate” will be invoked to permit an orderly liquidation of investments and therefore a more orderly exit from the fund.

Future of the Canadian Hedge Fund Industry

AIMA Canada recognizes that, as the hedge fund market continues to evolve inside and outside Canada, regulatory agencies will be reviewing existing regulation to ensure that it is broad enough to protect less sophisticated investors. AIMA Canada strongly supports proper and adequate regulation to protect retail investors. Significantly, in the United

States, the Securities and Exchange Commission has recently enacted rules to require hedge fund investment managers based in the U.S. or hedge funds selling to certain U.S. investors to be registered with the SEC – a requirement that most Canadian provinces have had in place for quite some time.

In summary, AIMA Canada sees continued strong growth in the Canadian hedge fund industry, which currently involves some of the largest and most sophisticated financial institutions in this country. The industry is both strong and fundamentally sound. AIMA Canada will continue to work with industry participants and Canadian regulatory authorities to promote the responsible use of alternative investments and to further our objective of increasing investor education, transparency and promote due diligence and related best practices.

Thank you.

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